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IN THE

# Supreme Court of the United States

**October Term, 1937**

**No. 29**

GUY T. HELVERING, Commissioner of Internal Revenue,
*Petitioner,*

*v.*

ANNIE M. PFEIFFER,
*Respondent.*

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

## BRIEF FOR RESPONDENT.

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

## BRIEF FOR RESPONDENT.

### Opinions Below.

The opinion of the Board of Tax Appeals (R. 35) is a memorandum opinion not officially reported. The opinions of the Circuit Court of Appeals (R. 43) are reported in 88 Fed. (2d) 3.

### Jurisdiction.

The judgment of the Circuit Court of Appeals was entered February 23, 1937 (R. 48). Petition on Certiorari was filed April 15, 1937 and was granted May 17, 1937 (R. 49). The jurisdiction of this Court rests on Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

## Questions Presented.

I. Is a dividend by a corporation in its own new and unissued Preferred Stock paid to holders of Common Stock, when there were other shares of Preferred Stock of the same classification outstanding a part of which were held by others than the common stockholders, subject to tax under Section 115 (f) of the Revenue Act of 1928?

II. Is such a Preferred Stock Dividend Income under the Sixteenth Amendment to the Constitution?

III. Should the Circuit Court of Appeals have passed upon—(1) the contention of the Commissioner that the shares of stock redeemed in 1931 had a zero basis; or (2) the alternative contention of the Commissioner that the amount received in redemption of such shares was taxable as a dividend under Section 115 (g) of the Revenue Act of 1928?

IV. If the question of the basis of the Dividend Stock is properly before this Court, what is the correct basis, assuming that such dividend was not subject to tax under the Statute at the time of its receipt;—is it *market value* or is it *zero*?

## Statutes Involved.

The important Statutes involved, if not quoted in the text, are contained in the Appendix.

## Statement of the Case.

This controversy arises out of a proposed deficiency in Federal Income Tax of the Responding Taxpayer for the year 1931.

*Facts.* William R. Warner Corporation, hereinafter called the "Corporation", was organized in 1920 under the Laws of Delaware, its stock at all times consisting of Common and non-voting Preferred. Each class of stock had a par value of $100 per share (R. 10). Dividends upon the Preferred Stock were never in default (R. 16). The authorized Capital Stock of the Corporation was increased several times by capitalizing its earnings (R. 11, 12, 13, 14).

In 1928 the Corporation issued and distributed 50,000 shares of the Preferred Stock, so authorized, as a dividend to the Common Stockholders of the Corporation in the ratio of one share of Preferred Stock to each two shares of Common Stock (R. 14).

In 1931 the Corporation issued and distributed 25,000 shares of Preferred Stock of the Corporation to the Common Stockholders as a dividend (R. 15), at a time when other Preferred Stock was outstanding, of which some was owned by the Common Stockholders (R. 15). The Taxpayer received, as her share of the 1931 distribution, 6,291¼ shares of Preferred Stock (R. 15). The market value of the shares so received was $629,125—their par value (R. 16).

Throughout these several recapitalizations, including the recapitalizations of 1928 and 1931, the terms, provisions and priorities of the two classes of Stock remained unchanged (R. 13). The earnings of the Corporation and its subsidiaries were far more than sufficient to pay the dividends on the Preferred Stock of the Corporation at any time outstanding (R. 16). Cash dividends were paid by the Corporation, as called for by its Preferred Stock, and large additional cash dividends were paid on the Common Stock during each of the years 1920 to 1931, inclusive (R. 16). The earned surplus of the Corporation and its subsid-

iaries on December 31, 1931, after the payment of the Stock Dividend in dispute, was $8,845,000 (R. 30).

In 1931 the Corporation redeemed with cash at par 8,500 shares of its Preferred Stock, including 2,000 shares belonging to the Taxpayer, which were a part of the Stock Dividend which she had received in 1928 (R. 16).

In her 1931 Income Tax Return the Taxpayer did not report as Income the 6,291¼ shares of Preferred Stock received by her as a Stock Dividend.

In her 1931 Income Tax Return the Taxpayer reported a capital gain of $180,100 as having resulted from the redemption of the 2,000 shares of Preferred Stock—a part of the shares issued to her in 1928 as a Stock Dividend—the gain having been determined in accordance with Regulations of the Treasury Department then effective, and paid a tax of $22,512.50 on such capital gain (R. 17).

*History of the Case.* The Commissioner, in determining the deficiency, included as taxable Income the sum of $629,125, representing the value of this Stock Dividend (R. 7). In addition, the Commissioner eliminated the capital gain of $180,100 and included as taxable income the sum of $200,000 received by the Taxpayer from such redemption (R. 7) as a taxable dividend under the provisions of Section 115 (g) of the Statute.

The Board of Tax Appeals held that the dividend paid in Preferred Stock in 1931 was not a "stock dividend" within the meaning of Section 115 (f) of the Revenue Act of 1928, and that such dividend was a taxable dividend. With respect to the 2,000 shares of stock issued in 1928 and redeemed in 1931, the Board held that, since in its opinion the Stock Dividend was subject to tax as Income when received in 1928, the redemption in 1931 was not essentially equiva-

lent to the distribution of a taxable dividend within the meaning of Section 115 (g).

On appeal by the Taxpayer to the Circuit Court of Appeals the Government contended that the Stock Dividend in question was not a "stock dividend" within the meaning of Section 115 (f) of the Statute and, therefore, was subject to Income Tax. This was the only issue raised on the appeal, the Government not having filed a cross appeal from the Board's decision on the application of Section 115 (g). Although no cross appeal was filed, the Government, in case stock dividends were held to be not subject to tax under the Statute, made the two following *alternative* contentions in its brief and oral argument before the Circuit Court of Appeals:

(1) That the Taxpayer realized a capital gain of $200,000 as a result of the redemption in 1931 of the 2,000 shares of Prefered Stock which she had received as a Stock Dividend in 1928, basing this contention upon the proposition that this Stock Dividend had a basis of zero.

This would result in a capital gain of $200,000 instead of $180,100, the amount originally reported by the Taxpayer in her Return. This contention was not made by the Commissioner in his Ninety-Day Letter nor in his Answer before the Board and was not urged before the Board nor raised by cross appeal to the Circuit Court of Appeals.

(2) In the event that the Court should hold that the basis of the redeemed Stock Dividend was not zero, the Government contends that the redemption in 1931 of a portion of the Preferred Stock dividend paid in 1928 was taxable as the essential equivalent to the distribution of a taxable dividend under Section 115 (g).

This alternative contention, if allowed, would result in adding $200,000 to the Taxpayer's income for 1931 in the

form of dividend Income. This contention was not raised by cross appeal.

The Government makes the same two alternative contentions in this Court.

*Decision of Circuit Court of Appeals.* The Circuit Court of Appeals held that the Preferred Stock Dividend received in 1931 was not subject to tax under Section 115 (f) of the Revenue Act of 1928.

The Court refused to sustain a deficiency *pro tanto* upon the theory that the cost basis of the stock sold to the Corporation during the taxable year, and previously received as a Stock Dividend in 1928, was zero, because this point was not raised before nor decided by the Board.

The Court also refused to consider whether the redemption of the Preferred Stock in 1931 was the equivalent of the distribution of a taxable dividend under Section 115 (g), because the Government did not file a cross appeal from the decision of the Board, and further because the Board did not find that the redemption of the Preferred Stock occurred at such time and in such manner as to make the redemption essentially equivalent to the distribution of a taxable dividend under the provisions of Section 115 (g).

## Preliminary Statement.

If this Court holds that the 1931 Preferred Stock dividend paid on Common Stock was exempt from taxation under the Statute (Section 115 (f) of the Revenue Act of 1928), it is immaterial, so far as the *taxability of such dividend* is concerned, whether it constituted "Income" under the Sixteenth Amendment to the Constitution. But it will be necessary on the question of *basis*, if for no other reason, to determine whether such stock dividend constituted In-

come under the Sixteenth Amendment, provided this Court holds that the question of the basis of the 1928 Preferred Stock dividend, a part of which was redeemed in 1931, was properly raised by the Commissioner on appeal.

The question, therefore, as to whether the stock dividends of 1928 and 1931, both of which were of the same character, constituted "Income" which Congress could have taxed under the Sixteenth Amendment to the Constitution will be discussed under Point II, following the discussion of the Statutory exemption.

## Summary of Argument.

### Point I.

All stock dividends—those that do and those that do not constitute Income—are specifically exempted from taxation under Section 115 (f) of the Revenue Act of 1928, which provided that "A stock dividend shall not be subject to tax".

The term "stock dividend" has been uniformly defined, both by courts and text-writers, as including *any dividend paid by a corporation in its own new or unissued stock.*

In the *Koshland* decision, in the Revenue Act of 1936 and in the Treasury Regulations appertaining thereto, the term "stock dividend" is applied to dividends which do, as well as those which do not, constitute Income.

The decision of this Court in the *Koshland* case recognized that all stock dividends were exempted from tax by Statute.

A consideration of the history of the legislation exempting stock dividends from tax discloses that the Treasury Department gave a broader interpretation to the decision of this Court in the *Macomber* case than was required by that decision, as now interpreted. The Regulations and

rulings of the Treasury Department, issued shortly after the *Macomber* decision, which continued uninterruptedly and were relied upon by taxpayers for over fourteen years, specifically provided that all stock dividends were immune from tax, whether constituting a distribution of common stock on common stock or a distribution of stock of a different quality or preference from that on which the dividend was paid.

Congress, relying upon and adopting the foregoing interpretation of the Treasury Department, exempted all stock dividends from taxation in the Revenue Act of 1921 and, with the knowledge that the Treasury Department was applying this exemption to all types of stock dividends, re-enacted such exemption in identical language in the succeeding five Revenue Acts. The re-enactment by Congress, without change, of a statute which had previously received long continued administrative construction, is an adoption by Congress of such construction.

## Point II.

Under the *Koshland* decision, a stock dividend constitutes Income if, as a result of the receipt of such dividend the stockholder's proportional interest is *essentially* different from his former interest. The interests of Respondent and the other stockholders of the Warner Corporation, after they received their Preferred Stock dividends, were substantially the same as before they had received such dividends—the dividends giving them nothing which added anything of value to what they had before or which could be measured in terms of Income. To the exact extent that the stockholders of the Warner Corporation received value

in the form of Preferred Stock, they suffered a diminution in value in their Common Stock. Hence, they should not be regarded as having received Income by virtue of the Preferred Stock distributed as a dividend.

## Point III.

The question of the taxability as a capital gain of the amount received upon the redemption in 1931 of stock issued as a dividend in 1928 was not an issue before, nor decided by, the Board of Tax Appeals. The Circuit Court of Appeals was, therefore, without authority to decide this question.

The question of the taxability, under Section 115 (g) of the Revenue Act of 1928, of the amount received upon the redemption in 1931 of the stock issued as a dividend in 1928 was decided by the Board adversely to the Government. No cross appeal having been taken by the Government, this question was not an issue before the Circuit Court.

## Point IV.

Assuming that the Preferred Stock received by Respondent in 1928 constituted Income, its basis for the purpose of determining gain or loss upon its subsequent redemption is its fair market value at date of receipt. This principle is well established by the decisions of this and other courts, which hold that, where property does not have a "cost" in the conventional sense and the applicable Revenue Act does not prescribe otherwise, the basis of such property, for the purpose of determining gain or loss upon subsequent disposition, is its fair market value when acquired.

# ARGUMENT.

## POINT I.

**All stock dividends—those that do and those that do not constitute Income—are exempt from taxation under Section 115 (f) of the Revenue Act of 1928.**

### *The Koshland Case.*

The question as to whether Congress, in Section 115 (f) of the Revenue Act, exempted from taxation *all* stock dividends—those which do and those which do not constitute Income to the shareholder—was squarely presented to this Court in the case of *Koshland* v. *Helvering,* 298 U. S. 441 (May 18, 1936). On this point this Court said at page 443:

> "The petitioner contends, first, that the dividends she received were not stock dividends exempted from taxation by the revenue acts; * * *. The respondent answers that the distributions were stock dividends because made in the capital stock of the corporation and come within the plain meaning of the provisions exempting stock dividends from income tax; * * *."

Indeed, practically the entire argument made by the Government in its brief in this Court in the *Koshland* case was in support of the proposition that:

> "The unambiguous language of the provision 'a stock dividend shall not be subject to tax' warrants the conclusion that Congress intended to exempt all stock dividends from tax * * *."

(Government's brief in the *Koshland* case, page 17.)

In its opinion in the *Koshland* case this Court said, at page 445:

> "Although *Eisner* v. *Macomber* affected only the taxation of dividends declared in the same stock as that presently held by the taxpayer, *the Treasury gave the decision a broader interpretation which*

> *Congress followed in the Act of 1921.* Soon after the passage of that Act, this court pointed out the distinction between a stock dividend which worked no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and such a dividend where there had either been changes of corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the stockholder after the distribution was essentially different from his former interest. *Nevertheless the successive statutes and Treasury regulations respecting taxation of stock dividends* remained unaltered." (Emphasis supplied.)

The above language has been generally accepted as indicating the opinion of this Court that Congress, in the Revenue Act of 1921 and subsequent Revenue Acts, exempted all stock dividends from tax.

This was clearly the view of Mr. Justice STONE and Mr. Justice CARDOZO who, in their dissenting opinion, said:

> "The meaning of the Act of Congress exempting stock dividends from taxation as income at the time of distribution has had a practical construction through administrative action and legislative acquiescence. Even though the meaning may have been uncertain in the beginning, it has now become fixed in accordance with long continued practice. • • • *This is not denied in the opinion of the court.*" (Emphasis supplied.)

The Board of Tax Appeals appears to have placed the same interpretation upon the *Koshland* decision. In the case of *Horrmann* v. *Commissioner*, 34 B. T. A. 1178 (October 21, 1936), the Board said:

> "But whether we are right or wrong in our interpretation of the Koshland case and whether or not the preferred stock dividend of 1922 was income, we

are of the opinion that it was not taxable to the stockholders. Of course, if it was a stock dividend within the compass of *Eisner* v. *Macomber*, it was not income under the Sixteenth Amendment; *if it was income as in the Koshland case, it was nevertheless a stock dividend which was specifically exempt from tax under section 201 (d) of the Revenue Act of 1921.*

"This exemption has been of long standing as pointed out in the opinion in the *Koshland* case. All of the revenue acts from 1921 to 1934, inclusive, have specifically provided for the exemption and the Treasury regulations over an equally long period of time have broadly held stock dividends nontaxable." (Emphasis supplied.)

The above statement would seem clearly to indicate that the Board of Tax Appeals concedes that its decisions in the case at bar and in the *Gowran* case and in all its prior decisions, including *Tillotson Manufacturing Company* v. *Commissioner*, 27 B. T. A. 913, on the question of the taxability of stock dividends under the Statute were erroneous, and is now of the opinion that all stock dividends are exempt from tax under the Statute.

The opinion of the Circuit Court of Appeals for the Second Circuit in the case at bar indicates that such Court interprets the opinion in the *Koshland* case as holding that all stock dividends are exempt from tax under the Statute.

It should be noted that the same Commissioner and the same Solicitor General, in the short space of one year, have changed their position as to the scope and meaning of Section 115 (f) in spite of the fact that the position taken by the Government in the *Koshland* case was based upon fifteen years of consistent administrative construction. The function of the Commissioner is to administer the Revenue Statutes consistently. Certainly the *Koshland* case does not require the Commissioner to change his position.

It is true that this Court said in the *Koshland* case that it was immaterial for the purposes of that case whether

Congress had taxed the dividends at the time of receipt. But the question of the taxability of the dividends under Section 115 (f) was present in the case, was argued by counsel, and was deliberately considered by the Court. It follows, therefore, that the implication in the language of the opinion that such dividends were exempted by the Statute from taxation, "if *dictum* * * * should * * * be regarded as *'judicial dictum'*, in contradistinction to mere *obiter dictum.*"

> *Buchner* v. *Chicago, N. & N. W. Railway Company,* 60 Wisc. 264, 268.

As stated in *Florida Central Railroad Company* v. *Schutte,* 103 U. S. 118, 143:

> "It cannot be said that a case is not authority on one point because, although that point was properly presented and decided in the regular course of the consideration of the cause, something else was found in the end which disposed of the whole matter."

The question presented for determination in the case at bar is, therefore, not merely whether the decision of the Circuit Court of Appeals—holding that *all* stock dividends were exempt from taxation under the Revenue Act of 1928—should be reversed, but also whether the plain implication of the opinion of this Court in the *Koshland* case should be overruled.

**The Term "Stock Dividend" is Free from Ambiguity and Embraces all Dividends Paid by a Corporation in its own New or Unissued stock.**

This Court has frequently stated that the language of an Income Tax Statute must be given its natural and ordinary meaning.

> *Lang* v. *Commissioner,* 289 U. S. 109;
> *Reinecke* v. *Smith,* 289 U. S. 172.

When the words in the Statute are clear and unambiguous, they are not open to speculative construction:

> "It is elementary that where no ambiguity exists there is no room for construction."
>
> *United States* v. *Missouri Pacific Railroad Company,* 278 U. S. 269, 277.

Applying this principle of construction to Section 115 (f) of the Revenue Act of 1928, it becomes immediately apparent that Congress, in providing that "a stock dividend shall not be subject to tax," intended to exempt from taxation all dividends comprehended within the term "stock dividend".

In 14 C. J. 812, the term "stock dividend" is defined as follows:

> "A dividend made payable by a corporation in new or unissued shares of its own stock is a stock dividend. (Citing cases)."

A similar definition is contained in Thompson on Corporations, Vol. 7, 3d Ed. (1927), page 137, where the term is defined as follows:

> "A stock dividend is what the term itself implies, a distribution of the stock of the corporation among the stockholders as a dividend."

Clark & Marshall, Private Corporations, Vol. 2, Section 523 e, page 1601:

> "A stock dividend is a dividend payable in reserved or additional stock of the corporation, instead of in cash or property."

*Gray* v. *Hemenway,* 212 Mass. 239, 98 N. E. 789:

> "Moreover by a stock dividend is generally understood a distribution made by a corporation of shares of its own stock."

As far as we have been able to ascertain, there is no authority, judicial or otherwise, in the entire field of corporation law for limiting the meaning of the term "stock dividend" to a distribution of common stock on common stock or to a distribution of stock of the same quality or preference as that on which the dividend was paid. *The Government does not contend otherwise.*

It was held in the *Koshland* case that some types of dividends paid by a corporation in its own stock constitute Income to the shareholder but other types do not; that a dividend in stock which effects no change in the proportional interest of the stockholder does not constitute Income within the intendment of the Sixteenth Amendment, while a dividend which *essentially* alters the stockholder's proportional interest is not constitutionally immune from taxation as Income.

This Court recognized, however, that both types of dividends—those which *do* and those which *do not* constitute Income—come within the definition of the term "stock dividend". Thus it is stated in the *Koshland* opinion, page 445:

> "Soon after the passage of that Act, this court pointed out the distinction between a *stock dividend* which worked no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and *such a dividend* where there had either been changes of corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the stockholder after the distribution was *essentially* different from his former interest." (Emphasis supplied.)

Even now, after the decision in the *Koshland* case, and after Congress in the Revenue Act of 1936 (Section 115 (f)) limited the exemption to such stock dividends as are constitutionally tax-free stock dividends, the Treasury recog-

nizes that both classes of dividends are properly designated "stock dividends".

In Article 115-7 of Regulations 94, relating to the Revenue Act of 1936, the following language is used:

> "The Supreme Court has pointed out some of the characteristics distinguishing a *stock dividend* which constitutes income from one which does not constitute income within the meaning of the Constitution. * * * A *stock dividend* constitutes income if it gives the shareholder an interest different from that which his former stock holdings represented. A *stock dividend* does not constitute income if the new shares confer no different rights or interests than did the old—the new certificates plus the old representing the same proportionate interest in the net assets of the corporation as did the old." (Emphasis supplied.)

Congress itself used the term "stock dividend" to describe both classes of dividends in Section 115 (f) of the Revenue Act of 1936 which reads as follows:

> "Stock Dividends.
>
> "(1) General Rule.—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution."

It is wholly immaterial whether the shares of stock received by the Taxpayer as a dividend did or did not constitute Income to her. Under the accepted definition, the dividend received by the Taxpayer was a "stock dividend" and was exempt from taxation by virtue of express language of Section 115 (f) of the Revenue Act of 1928 which provides that "a stock dividend shall not be subject to tax".

**A consideration of Section 115 (f) of the Revenue Act of 1928, in the light of its Legislative, Administrative and Judicial History, compels the conclusion that Congress intended to exempt all stock dividends from tax.**

As pointed out in the preceding Subdivision of this Point, the meaning of the term "stock dividend", as used in Section 115 (f) of the Revenue Act of 1928, is wholly free from ambiguity. A "stock dividend" is any dividend paid by a corporation in its own new or unissued stock. This being so, it is idle for the Government to argue that when Congress declared that "A stock dividend shall not be subject to tax", it was not thereby exempting a dividend paid by a corporation in its own unissued preferred stock ratably to the holders of its common stock.

Even if we assume, however, that the term "stock dividend" as used in the Statute is ambiguous, thereby opening the way to an independent consideration of the legislative intent, the circumstances under which the Statute was originally enacted and its subsequent reenactment after its administrative construction clearly establish that Congress intended to exempt all stock dividends from taxation.

The Congress in earlier Revenue Acts had already given a meaning to the term "stock dividend". Section 2 (a) of the Revenue Act of 1916, in so far as is here material, provided as follows:

> "That the term 'dividends' as used in this title shall be held to mean any distribution made or ordered to be made by a corporation * * * out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash, or *in stock of the corporation,* * * * which *stock dividend* shall be considered income, to the amount of its cash value." (Emphasis supplied.)

A similar provision was contained in the Revenue Act of 1917 (Section 31 (a)), and in the Revenue Act of 1918 (Section 201 (a) and (c)).

In *Eisner* v. *Macomber,* 252 U. S. 189, decided March 8, 1920, this Court determined that the stock dividend there involved was not Income within the meaning of the Sixteenth Amendment and that the Revenue Act of 1916 was invalid, in so far as it imposed a tax upon the stockholders because of the receipt of such a dividend.

The dividend involved in the *Macomber* case was paid in Common stock on Common stock, and the question whether stock dividends, other than Common on Common, were constitutionally immune from taxation was not presented. However, in addition to stating that the dividend in question did not "alter the pre-existing proportionate interest of any stockholder", this Court said at page 211:

> "A 'stock dividend' shows that the company's accumulated profits have been capitalized, instead of distributed to the stockholders or retained as surplus available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of the stockholder, it tends rather to postpone such realization, in that the fund represented by the new stock has been transferred from surplus to capital, and no longer is available for actual distribution.
>
> "*The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit;* on the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment. Having regard to the very truth of the matter, to substance, and not to

> form, he has received nothing that answers the definition of income within the meaning of the 16th Amendment." (Emphasis supplied.)

As indicated in the opinion of this Court in the *Koshland* case, at pages 444 and 445, the true import of the *Macomber* decision, as now interpreted, was not for some time recognized. This Court had held in the *Macomber* case not only that the stock dividend there involved effected no change in the stockholder's pre-existing proportionate interest, but also that the "controlling fact" was that the stockholder "received nothing out of the company's assets for his separate use and benefit". If the latter point were in fact the *ratio decidendi* of the *Macomber* case, all stock dividends would have been constitutionally immune from taxation, because in no case where a stockholder receives a dividend paid by a corporation in its own new or unissued stock does the stockholder receive anything "out of the company's assets for his separate use and benefit".

The Treasury Department considered the "severance" test controlling. Accordingly, shortly after the decision in the *Macomber* case, it promulgated Treasury Decision 3052, 3 C. B. 38 (August 4, 1920), expressly and unqualifiedly assuring taxpayers that all stock dividends were free from taxation:

> "The following applications of the decision of the Supreme Court of the United States in the case of *Eisner* v. *Macomber* in the determination of the taxability of dividends declared by corporations are published for the information and guidance of internal revenue officers *and others concerned:*
>
> "1. Where a corporation, being authorized so to do by the laws of the State in which it is incorporated, transfers a portion of its surplus to capital account, issues new stock representing the amount of the surplus so transferred, and distributes the stock so

> issued to its stockholders, such stock is not income to the stockholders, *and the stockholders incur no liability for income tax by reason of its receipt.*" (Emphasis supplied.)

Shortly afterwards, the Treasury Department issued Treasury Decision 3059, 3 C. B. 38 (August 16, 1920), revoking Article 1545 and amending Article 1547 of Regulations 45 issued earlier in 1920 under the Revenue Act of 1918 to provide that "stock received as a dividend does not constitute taxable income to the stockholder." This Treasury Decision prescribed a method for allocating the cost of the original shares between such shares and the dividend shares for the purpose of determining gain or loss upon the disposition of either, not only where the new stock was of the same character as the old, but also where the new was of a different character or preference. This Decision provided in part:

> "2. *Where the stock issued as a dividend is in whole or in part of a character or preference materially different from the stock upon which the stock dividend is paid,* the cost, or fair market value as of March 1, 1913, if acquired prior to that date, of the old shares of stock shall be divided between such old stock and the new stock, or classes of new stock, in proportion, as nearly as may be, to the respective values of each class of stock, old and new, at the time the new shares of stock are issued, and the cost of each share of stock will be the quotient of the cost of the class to which such share belongs divided by the number of shares in that class." (Emphasis supplied.)

Following the issuance of Treasury Decision 3059, *supra*, the Treasury Department issued O. D. 732, 3 C. B. 39 (1920), *giving more specific instructions as to the method of adjusting the cost of both classes of stock where preferred stock is issued as a dividend on common stock.*

Still later, O. D. 801, 4 C. B. 24 (January-June, 1921), stated as follows:

> *"A stock dividend paid in true preferred stock is exempt from tax the same as though the dividend were paid in common stock;* • • • " (Emphasis supplied.)

Thus it is clear that the Treasury Department interpreted the *Macomber* decision as holding that all stock dividends were constitutionally immune from taxation. This Court, in the *Koshland* case, at page 444, recognized this administrative construction, stating:

> "After the decision the Treasury revoked regulations to the effect that a dividend paid in the corporation's stock is income and issued amended regulations, broadly phrased, *to exempt all income in the form of stock dividends, whether the dividend shares be of the same class as those theretofore held by the stockholder or of a different class,* and prescribing the method of allocating the original cost as between the old and the new stock for purposes of calculating gain or loss upon realization." (Emphasis supplied.)

Subsequent to the promulgation of the Treasury Decisions and Office Decisions quoted above, the Revenue Act of 1921 was enacted and Congress, in Section 201 (d) of that Act, provided:

> "A stock dividend shall not be subject to tax • • •."

Congress, in the Revenue Act of 1921, not only expressly exempted all stock dividends from taxation, but also amended the definition of the term "dividend" as contained in the Revenue Acts of 1916, 1917 and 1918, and defined the term "dividend" as "any distribution made by a corporation to its shareholders, or members, whether in cash or in other property, out of its earnings or profits accumulated

since February 28, 1913". (Section 201 [a].) This explicitly eliminated from the definition of the term "dividend" a distribution made by a corporation in its own stock. (See page 17 of this Brief.)

The sequence of events was that the *Macomber* decision was handed down on March 8, 1920; the Treasury Department rendered its so-called "severance test" Decisions in August, 1920; the Revenue Act of 1921 was passed on November 23, 1921.

As indicated by House Reports No. 350, Sixty-seventh Congress, 1st session, page 8, and Senate Reports No. 275, Sixty-seventh Congress, 1st session, page 9, the *Macomber* decision was the underlying reason for the adoption of Section 201 (d) of the Revenue Act of 1921. (This is also shown by the Debates in Congress.)

On October 19, 1921, Senator McCumber, as reported in Volume 61, Congressional Record, page 6474, in answering Senator Nelson's criticism that the proposed bill did not tax stock dividends, said:

> "If the Senator will read the Supreme Court decision carefully, he will find that the reason given for holding that you could not levy a tax upon the undistributed profits of a corporation, even though they were in the form of dividend certificates, *was that the taxpayer was not in possession and control of the funds, and he could not be taxed upon funds which were not his, and over which he had no control.* That was the basis of the decision, and that being the basis of the decision, you could not by any character of language tax those funds while they were still in the hands of the corporation. You could not tax them as against the holder of the certificates. That, I think, was the reason which actuated every member of the committee, so far as I know." (Emphasis supplied.)

It thus appears obvious that Congress followed the interpretation of the *Macomber* decision that had been placed

upon it by the Treasury Department, and intended to and did exempt from taxation *all stock dividends.* Such a conclusion is borne out by the opinion of this Court in the *Koshland* case, at page 445:

> "Although Eisner v. Macomber affected only the taxation of dividends declared in the same stock as that presently held by the taxpayer, *the Treasury gave the decision a broader interpretation which Congress followed in the Act of 1921.*" (Emphasis supplied.)

The Treasury Department was not alone in construing the *Macomber* decision as establishing the "severance" test as the controlling test. Leading Constitutional authorities likewise generally understood that the severance test was the controlling test established by the *Macomber* case in determining whether a stock dividend was constitutionally immune from taxation.

> *Stock Dividends, Direct Taxes and the Sixteenth Amendment,* by Thomas Reed Powell, Columbia Law Review, Vol. 20, p. 536 (1920);
> *Corporate Personality in Income Taxation,* by Arthur A. Ballantine, Harvard Law Review, Vol. 34, p. 573 (April, 1921);
> *Stockholders and the Federal Income Tax,* by Joseph H. Beale, Harvard Law Review, Vol. 37, p. 1 (November, 1923).

The comments on the *Macomber* decision in the opinions of the Judges of the House of Lords in the case of *Commissioners of Inland Revenue* v. *Blott,* 8 Tax Cases, 101 (1921), also indicate that the House of Lords considered "severance" to have been the test applied in the *Macomber* case. In these opinions a part of the opinion of Mr. Justice PITNEY in the *Macomber* case was quoted.

The intention of Congress is to be gathered from the words of the Act interpreted according to their ordinary acceptation, and, when it becomes necessary to do so, in the light of the circumstances as they existed when the Statute was passed.

*Platt* v. *The Union Pacific Railroad Company*, 99 U. S. 48 (1879);
*Louisville & Nashville Railroad Company* v. *Mottley*, 219 U. S. 467 (1911).

If, therefore, it be thought necessary to resort to the circumstances existing at the time of the enactment of the Statute, what could be more cogent evidence of the general understanding of the *Macomber* decision than the interpretation given to such decision by the Treasury Department and the Committees of Congress and by such distinguished Constitutional authorities. All these concurred in interpreting the *Macomber* decision as resting upon the basis that a stock dividend is not Income to the recipient stockholder because "the stockholder has received nothing out of the company's assets for his separate use and benefit". *Eisner* v. *Macomber, supra.*

After the enactment of the Revenue Act of 1921, the Treasury Department in 1922 issued Regulations 62, interpretative of that Act. Article 1548 of such Regulations provides, in part, as follows:

> "*Stock issued by a corporation as a dividend does not constitute taxable income to a stockholder of such corporation,* but gain may be derived or loss sustained by the stockholder from the sale of such stock." (Emphasis supplied.)

Congress re-enacted the identical provision of the Revenue Act of 1921—"A stock dividend shall not be subject to tax"—as Section 201 (f) of the Revenue Acts of 1924 and

1926 and Section 115 (f) of the Revenue Acts of 1928, 1932, and 1934.

The Treasury Regulations interpretative of the subsequent Revenue Acts, including Article 628 of Regulations 74 promulgated under the Revenue Act of 1928 which is directly applicable to the instant case, contain substantially the same unequivocal grant of exemption, as is declared in Article 1548 of Regulations 62, above quoted.

> Article 1548 of Regulations 62, under the 1921 Revenue Act; Article 1548, Regulations 65, 1924 Act; Article 1548, Regulations 69, 1926 Act; Article 628, Regulations 74, 1928 Act; Article 628, Regulations 77, 1932 Act, and Article 115-8, Regulations 86, 1934 Act.

Subsequent Treasury Decisions and rulings are uniformly to the same effect:

> Office Decision 732, 3 C. B. 39 (1920); O. D. 735, 3 C. B. 40 (1920); O. D. 859, 4 C. B. 24 (1921); O. D. 801, 4 C. B. 24 (1921); Solicitor's Opinion, 144, C. B. 1-2, 4 (1922); A. R. R. 1127, C. B. 1-2, 8 (1921); I. T. 1930, C. B. III-1, 39 (1924) T. D. 3553 and T. D. 3554, C. B. III-1, 38 (1924); I. T. 1900, C. B. III-1, 82 (1924); G. C. M. 916, C. B. VI-1, 135 (1927); I. T. 2449, C. B. VIII-1, 101 (1929); G. C. M. 6709, C. B. VIII-2, 132 (1929); I. T. 2538, C. B. IX-1, 144 (1930).

Four years after the decision in the *Macomber* case the opinion in that case was reviewed and analyzed by this Court in *Weiss* v. *Stearn* (decided May 26, 1924), 265 U. S. 242, the Court stating at page 253:

> "*Eisner* v. *Macomber*, 252 U. S. 189, * * * gave great consideration to the nature of income and stock dividends. It pointed out that, within the meaning of the 16th Amendment, income from capital is gain severed therefrom and received by the taxpayer for his separate use; that the interest of the stockholder

> is a capital one and stock certificates but evidence of it; that, *for purposes of taxation, where a stock dividend is declared, the essential and controlling fact is that the recipient receives nothing of the company's assets for his separate use and benefit.*" (Emphasis supplied.)

The question involved in the case of *Weiss* v. *Stearn* was whether Income was derived from the exchange of shares of stock in one corporation for shares of the same character in a second corporation organized to take over its assets and business. The Court applying the general principles of the *Macomber* case held that no Income was derived from the transaction.

A year after the case of *Weiss* v. *Stearn* was decided, this Court rendered its decision in *Marr* v. *United States,* (decided June 1, 1925) 268 U. S. 536. The same general question was involved as in the case of *Weiss* v. *Stearn.* One distinction was that in the *Weiss* case the new shares possessed the same essential characteristics as the old, whereas in the *Marr* case the characteristics of the old and new shares were essentially different. Accordingly, the shareholder was held to have realized Income upon the exchange, the Court stating at pages 541; 542:

> "The case at bar is not one in which, after the distribution, the stockholders have the same proportional interest of the same kind in essentially the same corporation."

It is important to note that in the *Marr* case four of the Justices dissented upon the ground that *Weiss* v. *Stearn* turned "upon the approved definition of income from capital as something severed therefrom and received by the taxpayer for his separate use and benefit".

The case of *Marr* v. *United States* involved a distribution in reorganization, not a stock dividend, and the Treasury Department, even after this decision, still adhered to

the "severance" test in determining whether a corporate distribution constituted Income. Thus in 1929 the General Counsel for the Bureau of Internal Revenue ruled that, under Section 115 (f) of the Revenue Act of 1928, a stock dividend paid by a corporation in a class of stock different from that upon which the dividend was paid, did not constitute Income. G. C. M. 6709, VIII-2 C. B. 132. In support of his ruling the General Counsel stated:

> "The stockholder receives nothing out of the corporation's assets for his individual use, and those assets still remain the property of the corporation, subject to all the hazards of the business. He does not receive 'income'; the corporation is none the poorer, and the stockholder is none the richer. There is merely a transfer of surplus to capital account, although the number of shares issued and outstanding is increased. Such dividends would not, under *Eisner* v. *Macomber,* supra, be taxable."

It was not until March 14, 1935, when the Circuit Court of Appeals for the Sixth Circuit, rendered its opinion in *Tillotson Manufacturing Company* v. *Commissioner,* 76 Fed. (2d) 189, that the *Weiss* and *Marr* decisions were applied by the courts to stock dividends and the ruling announced that a stock dividend which results in a substantial alteration in a stockholder's pre-existing proportionate interest constitutes Income.

It is therefore readily understandable why, until after the decisions of the Circuit Court in the *Tillotson* case and of this Court in the *Koshland* case, no change was made in the provisions of the successive Revenue Acts nor in the Treasury Regulations unqualifiedly granting exemption to all stock dividends.

The Government now argues (in direct contradiction to its argument before this Court in the *Koshland* case) that Congress was exempting stock dividends only because it

believed that it was required to do so by the *Macomber* case, and that consequently it was not exempting such stock dividends as constituted Income.

But, as already illustrated, the true import of the *Macomber* decision, as now interpreted, was not realized in 1921. Admittedly, the Treasury Department, when in 1920 it amended Article 1547 of Regulations 45, interpreted the *Macomber* decision as holding *that no stock dividend* can constitute Income and, as pointed out in the *Koshland* case, it was the interpretation that the Treasury Department gave to the decision in the *Macomber* case "which Congress followed in the Act of 1921".

The fallacy of the Government's argument lies in the fact that it attributes to Congress knowledge in 1921 of a principle of law that was not suggested until the *Marr* decision in 1925 and not definitely established by this Court until the *Koshland* decision in 1936—viz., that certain types of stock dividends do constitute Income.

The foregoing consideration of the legislative, administrative and judicial history of the successive Revenue Acts conclusively demonstrates, it is submitted, that Congress, at the time of the enactment of the Revenue Act of 1921, intended to exempt *all stock dividends.* The Treasury Department, Congress, and others concerned believed that under the *Macomber* decision all stock dividends were immune from taxation.

As already pointed out, the Treasury Department in the Regulations and Rulings promulgated under the Revenue Act of 1921 and successive Revenue Acts uniformly interpreted the "stock dividend" provision as exempting all stock dividends.

The rule is well established by decisions of this Court that a regulation of an administrative department, such as the Treasury Department, if not in violation of an express

statutory provision, possesses the same effectiveness and sanction as statutory law. In *Maryland Casualty Company* v. *United States,* 251 U. S. 342, 349, this Court said:

> "It is settled by many recent decisions of this court that a regulation by department of government, addressed to and reasonably adapted to the enforcement of an act of Congress, the administration of which is confided to such department, has the force and effect of law if it be not in conflict with express statutory provision."

Furthermore, the repeated re-enactment by Congress of the provision exempting stock dividends, without change or modification, is convincing evidence of the explicit sanction and approval by Congress of the administrative construction of the Statute.

In *National Lead Company* v. *United States,* 252 U. S. 140, 146, this Court declared this principle as follows:

> "During all the intervening twenty-four years this rule of the Department with respect to drawbacks had been widely applied to many articles of much greater importance than linseed or its derivatives, and the practice was continued, linseed included after 1894, until the petition in this case was filed. *The re-enacting of the drawback provision four times, without substantial change, while this method of determining what should be paid under it was being constantly employed, amounts to an implied legislative recognition and approval of the executive construction of the statute (United States* v. *Philbrick, supra; United States* v. *Falk,* 204 U. S. 143, 152, 51 L. ed. 411, 414, 27 Sup. Ct. Rep. 191; *United States* v. *Cerecedo Hermanos y Compania,* 209 U. S. 337, 52 L. ed. 821, 28 Sup. Ct. Rep. 532), for Congress is presumed to have legislated with knowledge of such an established usage of an executive department of the government (*United States* v. *Bailey,* 9 Pet. 238, 256, 9 L. ed. 113, 120)." (Emphasis supplied.)

In *United States* v. *Cerecedo Hermanos y Compania*, 209 U. S. 337, this Court unequivocally stated this rule:

> "And we have decided that the re-enactment by Congress, without change, of a statute which had previously received long-continued executive construction, is an adoption by Congress of such construction." (p. 339).

The Government does not deny that under its consistent administrative interpretation of Subdivision (f) *all stock dividends* were exempted from tax. Nor does the Government claim that the Regulations and rulings evidencing such interpretation contravened the Statute exempting stock dividends from tax. The Government attempts, however, to avoid the effect of the Regulations and rulings by contending that "the administrative interpretation of the meaning of 'stock dividends' in Subdivision (f) was at all times integrated with the apportionment of the cost basis of the original stock between the original stock and the stock received as a dividend thereon," and that since such apportionment was held to be invalid in the *Koshland* case "the interpretation of the stock dividend exemption • • • must also necessarily fail". (Government's Gowran brief, p. 23, to which this Respondent is referred.)

It is immaterial whether or not the two portions of the Regulation were "integrated". The portion of the Regulation wherein the Commissioner interpreted Subdivision (f) as exempting *all stock dividends* from tax *admittedly* represented the construction *actually* placed upon Subdivision (f) by the Commissioner. That Subdivision as thus construed by the Commissioner was re-enacted, without change, in Section 201 (f) of the Revenue Acts of 1924 and 1926 and Section 115 (f) of the Revenue Acts of 1928, 1932 and 1934. Under the well established principle consistently enunciated by this Court, such re-enactment by Congress,

without change, of subdivision (f) was "an adoption by Congress of such construction". *U. S.* v. *Cerecedo Hermanos y Compania, supra.*

Moreover, it is not accurate to argue, as the Government does (relying upon the dissenting opinion of Judge LEARNED HAND) that there has never been any administrative interpretation of Section 115 (f) which did not immediately connect it with the method of calculating "basis". There are many administrative interpretations of Section 115 (f) which make no reference to the question of basis. O. D. 801, 4 C. B. 24 (1921); O. D. 859, 4 C. B. 24 (1920); I. T. 2449, C. B. VIII-1, 101 (1929); G. C. M. 6709, C. B. VIII-2, 132 (1929); I. T. 2538, C. B. IX-1, 144 (1930).

Even however, if the rulings and Regulations be eliminated from consideration, the Government gains no comfort therefrom. For the fact still remains that Congress exempted all stock dividends from taxation at time of receipt—in language which is plain and which fully gave effect to the legislative intent.

The conclusion that Congress in the six successive Revenue Acts from 1921 to 1934 used the term "stock dividend" in its ordinarily accepted sense—as any dividend paid by a corporation in its own new or unissued stock—is further fortified by the change in the law made by the Revenue Act of 1936 (Section 115 (f)), which limited the exemption to stock dividends constitutionally exempt from taxation.

It is a familiar canon of statutory construction that:

> "The deliberate selection of language so differing from that used in the earlier acts indicates that a change of law was intended."
>
> *Brewster* v. *Gage,* 280 U. S. 327, 337.

The Report of the Ways and Means Committee of the House of Representatives, submitted to the House on April 21, 1936, which accompanied the "Revenue Bill of 1936",

known as H. R. 12395, establishes a legislative purpose to amend the Statute—not to clarify the existing law. The Report of the Ways and Means Committee, Report No. 2475, 74th Congress, 2nd Session, p. 10, states, in part, as follows:

> "It may be well to note the more important of certain miscellaneous *changes* recommended in existing law.
>
> * * * * * * *
>
> "It is provided in Section 115(f) that stock dividends shall be subject to tax to the extent that such dividends constitute income to the shareholder within the meaning of the sixteenth amendment to the Constitution." (Emphasis supplied.)

The remarks of Representative Vinson, who was in charge of the 1936 Revenue Bill in the House of Representatives, made on the floor of the House while Congress was considering the Revenue Bill of 1936, evidence a clear and certain legislative purpose to revoke the complete exemption previously granted by Congress and to substitute therefor a legislative exemption identical in extent with the constitutional exemption protecting stock dividends from taxation. These remarks further demonstrate that the sponsors of the Bill were cognizant of the fact that Congress, in the earlier Revenue Acts, had expressly exempted all stock dividends from taxation.

On April 27, 1936, Representative Vinson made the following statement, which is reported in the Congressional Record of that day at page 6214:

> "Coming now to stock dividends, this is a field that has more or less been surrounded with mystery. *Existing law provides that no tax shall be levied upon stock dividends. We strike that from this bill.* There are innumerable types of stock dividends that are taxable under the Constitution and under the celebrated case of *Eisner versus Macomber.*" (Emphasis supplied.)

The Government, in quoting from the Congressional Record giving the debate in the House on the stock dividend question, does not quote the statement made by Representative Vinson on April 27, 1936 above given. This quotation shows that Representative Vinson, who was in charge of the Bill, clearly understood that a change in the existing law was intended and that he so informed the House. Upon this preliminary statement of Representative Vinson all the following debate hangs.

On April 28, 1936, the following colloquy took place between Representative Vinson and Representative Treadway (Congressional Record of that day at p. 6309):

> "Mr. Treadway. May I ask the gentleman one question?
>
> "I think he has covered subdivision (j) very thoroughly. Now, referring to section (f), taxable stock dividends, which is, of course, entirely new, that is, the principle is entirely new in that there is a set-up there under which stock dividends can be taxed, which has not been in the previous law. I am correct in that?
>
> "Mr. Vinson of Kentucky. If the gentleman from Massachusetts will permit, under the 1934 act there was a provision that said no stock dividend should be taxed. In a very celebrated case, Eisner against Macomber, the Supreme Court held that the tax (sic) dividend involved in that case was not taxable. *Out of that case grew up the idea that no stock dividend was taxable. I think it was because of that notion that the language to which I have referred, as appears in the 1934 bill, found its way there; that is, that no stock dividend should be taxed.*
>
> "The proposed plan does not change the law and does not in the slightest degree strike at the decision of the Supreme Court in the case of Eisner and Macomber in respect of a stock dividend where there is no change in the proportion of ownership by the shareholder.
>
> • • • • • • • • •

"Mr. Treadway. The language stricken out, I may say, reads as follows:

"(b) (sic) Stock dividends: A stock dividend shall not be subject to tax.

"That is the existing law and has been the law most of the time since the Eisner against Macomber decision. In the next tax bill after that decision that language was included.

"I understand the gentleman's explanation to be that the language of the act was too broad. I do not mean too broad in the sense it is not legal, but it goes further than the Eisner against Macomber decision.

"Mr. Vinson of Kentucky. That is correct.

"Mr. Treadway. The language now substituted for the stricken language describes new stock dividends that can be taxed or what portion of stock dividends under the sixteenth amendment can in the future be taxed. Is that the right conception of the intention?

"Mr. Vinson of Kentucky. Well, we take the broad position that stock dividends that are taxable income within the sixteenth amendment are subject to taxation, and if they are not such stock dividends and not any taxable income under the sixteenth amendment, they are not subject to taxes." (Emphasis supplied.)

The Government has quoted a portion of the foregoing colloquy between Representatives Vinson and Treadway and attempts to draw therefrom the conclusion that the change of language in Section 115(f) in the 1936 Act amounted merely to a clarification of existing law rather than a change in law. Apparently this conclusion is predicated upon the isolated words of Mr. Vinson constituting only a small portion of a single sentence. The full sentence with the italicized language corresponding to the italicized portion of the Government's brief reads as follows:

> "*The proposed plan does not change the law* and does not in the slightest degree strike at the decision of the Supreme Court in the case of Eisner and Macomber in respect of a stock dividend where there is no change in the proportion of ownership by the shareholder."

It is obvious from even a cursory reading of the foregoing quotation that the italicized words are definitely qualified and limited by the phrase "where there is no change in the proportion of ownership by the shareholder." So, properly read and understood, Mr. Vinson's statement must be taken to mean that "The proposed plan does not change the law . . . in respect of a stock dividend where there is no change in the proportion of ownership by the shareholder." That this is the proper meaning and interpretation is further evidenced by reference to the entire discussion reproduced on pages 33-34 of this brief, from which it is fair to deduce that the prior existing law provided that no tax should be levied upon any stock dividends; that such provision had its origin in the notion that under the decision of this Court in the *Macomber* case no stock dividend was taxable; that, as subsequently interpreted by this Court, the language of the earlier Statutes went further than was required by the *Macomber* decision; that the proposed language of the 1936 Act narrowed the scope of the prior existing law so as to provide explicitly that stock dividends constitutionally taxable shall be subjected to tax and stock dividends constitutionally immune from taxation shall not be subjected to tax; and that such new provisions do not strike at the decision of this Court in the *Macomber* case, as now interpreted.

Considering the change of language in Subdivision (f) of Section 115 of the Revenue Act of 1936 in conjunction with all of the other circumstances adverted to, the fact that the Statute was amended in 1936 is additional evidence

in support of the conclusion that under Section 115 (f) of the Revenue Act of 1928, all stock dividends whether or not resulting in Income to the stockholders, were exempt from tax.

**The Brief of the Government.**

In conclusion a word as to the general tenor of the Government's argument.

The Government does not deny that the Statute providing that "a stock dividend shall not be subject to tax" is free from ambiguity and that the term "stock dividend" by its universally accepted definition includes those stock dividends which are constitutionally subject to tax, as well as those which are constitutionally immune from tax. But it attempts to relieve itself of the consequences of being forced to this position by arguing in this fashion:

> The intent of Congress will prevail over the literal meaning of the Statute. The object of the statutory exemption "was to comply with the Constitution, as interpreted in the *Macomber* case. There is no evidence in the legislative history of the Revenue Act of 1921 or subsequent Acts of a policy behind the exemption of stock dividends other than the recognition of a constitutional limitation" and no other policy of exemption "can reasonably be imagined". That this was the object of Congress is "evidenced by the fact that in the Revenue Act of 1921 and all Revenue Acts thereafter, Congress sought to reach distributions which might otherwise be exempted under the *Macomber* case by providing that stock dividends redeemed under such circumstances as to constitute payment of a taxable dividend should be taxed as such". The "evident intent of Congress in income taxation is to use its power under the Sixteenth Amendment to the full extent. It is unreason-

able to suppose that Congress at the same time and for no apparent reasons of policy intended to exempt stock dividends which were within its taxing power." (Petitioner's brief in *Gowran* case, pp. 14-19.)

Assuming that this argument of the Government is fairly based upon and justified by the facts, which, we submit, of course, it is not, its fallacy may best be exposed by reference to the language of this Court in *Iselin* v. *United States*, 270 U. S. 245, 250:

> "It may be assumed that Congress did not purpose to exempt from taxation this class of tickets. But the act contains no provision referring to tickets of the character here involved; and there is no general provision in the act under which classes or tickets not enumerated are subjected to a tax. * * * The statute was evidently drawn with care. Its language is plain and unambiguous. What the government asks is not a construction of a statute, but, in effect, an enlargement of it by the court, so that what was omitted, presumably by inadvertence, may be included within its scope. To supply omissions transcends the judicial function."

Whatever Congress might have done, had it been prophetic enough in 1921 to foresee the decision of this Court in 1936 in the *Koshland* case, this fact stands unchallenged by the Government in its brief: The general, if not the universal, understanding of the opinion and decision in the *Macomber* case was that the "severance test" was controlling, and that accordingly no stock dividend could be subject to tax under the Constitution. This was the understanding of the Treasury Department, which made the Regulations. This was the understanding of Congress, which passed the Revenue Act of 1921, as clearly appears from the Reports of Debates in the House prior to the passage of the Act. This was the understanding of later Con-

gresses, which re-enacted the 1921 Statute, with the repeated endorsements of the Treasury Department Regulations and a continuous administrative construction and application. This was the understanding of legal authorities both in this country and abroad, who considered and wrote upon the subject. Finally, this was the understanding of the taxpayers who, in reliance upon such construction, declared and accepted stock dividends.

It by no means follows, because an erroneous understanding of the *Macomber* decision may have supplied the *motive* for the statutory exemption of stock dividends, that the legislative *intent* was other than to exempt *all* stock dividends from taxation. If we are permitted to go beyond the plain language of the Statute, the *intent* of Congress must be ascertained from its *actual* understanding of the *Macomber* decision, whether such understanding was right or wrong. If the actual understanding was that all stock dividends were constitutionally immune from taxation, the legislative intent must have been to give complete exemption to all stock dividends. If, on the other hand, it be assumed that Congress knew that certain types of stock dividends were taxable under the Constitution, then it must be assumed that Congress deliberately exempted such stock dividends from tax, since the language of the exemption will admit of no other construction.

The original prototype of Section 115 (f) of the 1928 Act was "drawn with care. Its language is plain and unambiguous." *Iselin* v. *United States, supra.* Under such circumstances, far from there being an intent on the part of Congress differing from the literal meaning of the words exempting all stock dividends from taxation, there was a specific intention of Congress to make such exemption effective as to all stock dividends. Precise language was used to effect that intention. It avails not the Government to argue that the Treasury Department and Congress misin-

terpreted the scope of the *Macomber* decision so that Congress mistakenly, *though intentionally,* exempted all stock dividends from taxation at time of receipt. Such an argument has no relation to the construction of a statute, but, on the contrary, is a request to this court to exercise retroactively legislative rather than judicial functions. That the Government recognized this fact is best evidenced by the manner and substance of its argument before this Court in the *Koshland* case and by the fact that the Treasury Department has caused Congress, in the Revenue Act of 1936, to change the law in respect of this matter.

The principle sought to be invoked by the Government, viz, that the evident intent of Congress in income taxation is to use its power under the Sixteenth Amendment to the full extent is inapplicable. If that principle were to be applied to a case such as this, then the functions of this court in respect of all matters of taxation would be limited to determining whether or not a given transaction has resulted in the realization of income under the Constitution and, having determined this question in the affirmative, to subject such income to taxation, irrespective of or in opposition to the specific provisions of the applicable Revenue Acts.

The position of the Government in this case and in the *Gowran* case is unfortunate, both from the standpoint of those charged with the administration of the law and of the taxpayers who look to their Government for fair treatment.

Both before the Board of Tax Appeals and the Appellate Courts, the Government strongly urged both in the *Tillotson* case and in the *Koshland* case that all stock dividends were exempt from tax. Its position in those cases was consistent with the position of the Treasury Department since 1920. This Court in its decision in the *Koshland* case, as hereinbefore pointed out, held invalid the Regulations requiring the adjustment of the cost of stock on which a

stock dividend had been paid. This Court, however, in its decision in the *Koshland* case used language which seemed to leave no doubt as to its belief that Congress had made the exemption broad enough to cover all types of stock dividends. Notwithstanding this clear indication that this Court agreed with the Government's original interpretation of Section 115 (f), the Government in this case and in the *Gowran* case is now urging that it has been wrong for the past fourteen years, and is now attempting to find some hidden intent of Congress behind the simple and precise wording of Section 115 (f). Yet, as late as 1935 in its Brief before the Circuit Court of Appeals in the *Koshland* case, it said at page 17:

> "The words of the Statute, however, are broad and unambiguous, that all stock dividends are not subject to tax, and we submit there is no reason to assume that the relief from taxation is restricted to the limited class of stock dividends which are constitutionally exempt from income taxation. The words of the statute should be given their plain and generally accepted meaning."

Again as late as 1936, in its Brief in the *Koshland* case, in this Court the Government, by the same counsel who is on the Brief in this case and in the *Gowran* case, said at page 17:

> "This conclusion finds support in the fact that Congress placed no limitation or classification on the nature or type of stock dividend exempted from tax and used language which is so plain in meaning as not to justify resort to Committee Reports for ascertainment of intention."

We close this point of this Brief with the foregoing words of the Government's own Counsel in support of the position of the Respondent in this case.

## POINT II.

**Is a dividend of Preferred Stock paid to holders of Common Stock, when there were other shares of Preferred Stock of the same classification outstanding, taxable as Income under the Sixteenth Amendment to the Constitution?**

We believe that this Court will conclude:

1. That Congress in Section 115 (f) has exempted *all* stock dividends from tax. (See Point I of this Brief.)

2. That the question of the basis to Respondent of the Preferred shares redeemed in 1931 is not properly before this Court. (See Point III of this Brief.)

But if we are mistaken on either point, it will be necessary for this Court to determine whether the dividends paid on the Common Stock in the form of Preferred shares constituted Income at the time of receipt.

This Court has directly ruled:

1. That a dividend of Common on Common does not constitute Income under the Constitution.

*Eisner* v. *Macomber, supra.*

2. That a dividend of Common on Preferred—there being shares of Common already outstanding—does constitute Income under the Constitution.

*Koshland* v. *Helvering, supra.*

To the same effect is:

*Tillotson Manufacturing Company* v. *Commissioner, supra.*

As pointed out by this Court in the *Koshland* decision, the distinction between the two foregoing types of stock

dividend is that in the former case "the same interest in the same corporation" was "represented after the distribution by more shares of precisely the same character", whereas in the latter case there had been "a change in the nature of the shares issued as dividends whereby the *proportional* interest of the stockholder after the distribution was *essentially* different from his former interest". (Emphasis supplied.)

Between these two extremes lies an uncharted field—covering situations, among others, where the dividend is in the form of Preferred upon Common shares with or without outstanding Preferred shares of the same or superior rank. There is also the situation where all the stock of a corporation is owned by one stockholder—in which case it seems obvious that no distribution of new or additional shares, whether of the same or a different class, to the sole stockholder effects any increase or essential change in his interest. That these intermediate factual situations involve a question of degree is evidenced by the following conclusions reached upon the subject:

1. A dividend of Preferred on Common when there is no other Preferred of the same classification outstanding has been held not to constitute Income under the 16th Amendment.

*Clark* v. *Commissioner*, 28 B. T. A. 1225, affd. 77 Fed. (2d) 89 (C. C. A. 3) without passing upon the Constitutional issue;

*Brown* v. *Commissioner*, 26 B. T. A. 901, affd. 69 Fed. (2d) 602 (C. C. A. 7) without passing on the Constitutional issue; certiorari denied, 293 U. S. 570;

*Horrmann* v. *Commissioner, supra.*

2. A dividend of Preferred on Common when there is other Preferred of the same classification outstanding

has been held to constitute Income under the 16th Amendment.

*Torrens* v. *Commissioner*, 31 B. T. A. 787; settled without decision by the Circuit Court of Appeals.

*Gowran* v. *Commissioner*, 32 B. T. A. 820, reversed 87 Fed. (2d) 125 (C. C. A. 7) without passing upon the Constitutional question.

The foregoing, we believe, is a complete judicial history of the interpretation by the Board of Tax Appeals, the Circuit Court of Appeals and this Court of the power of Congress to impose an Income Tax on stock dividends under the Constitution.

The principle of law, as now established by this Court, is clear, viz., that Congress may tax as Income under the 16th Amendment any stock dividend whereby the *proportional* interest of the stockholder after the distribution becomes *essentially* different from his former interest. But the application of that principle to the various intermediate factual situations presents serious difficulties.

That Congress recognizes that there is still doubt as to just what stock dividends constitute Income is shown by the provisions of the Revenue Act of 1936 (Sec. 115 (f)). Instead of a simple provision taxing any dividend paid by a corporation in shares of a classification or preference different from the shares on which the dividend is paid, Congress avoided the issue by providing that stock dividends shall be taxed to the extent that they constitute Income within the meaning of the 16th Amendment.

Certain it is that in the *Koshland* case the receipt by the taxpayer of Common Shares as a dividend did not diminish in any respect the taxpayer's interest in her Preferred Stock. The Preferred Stock continued to possess the same preferences and to have the same value as it had

prior to the distribution of the Common Stock dividend. Thus, the taxpayer's interest in the corporation was increased both absolutely and proportionately to the extent of the fair market value of the Common Shares issued as a dividend upon her Preferred Stock.

Equally certain it is that in the instant case the receipt by this Taxpayer of her Preferred Stock dividend neither increased nor essentially changed her absolute or proportional interest in the corporation, since its immediate and necessary effect was to dilute and diminish the value of her Common Stock interest to the exact extent of the par value of her Preferred dividend shares. This fact can be mathematically demonstrated. Since these Preferred shares were issued ratably to the Common stockholders, the practical effect upon each such stockholder was simply to subordinate his holdings of Common Stock, both as to dividends and distribution of assets, to that proportionate part of the new issue of Preferred which was distributed to him.

In the instant case the same corporation continued in existence, under the same management and with the same officers, and transacted the same business in precisely the same fashion as prior to the distribution of the Preferred Stock dividend. The voting rights remained unchanged, the Preferred Stock having no vote.

The interests of the four Warner common stockholders after they received their Preferred Stock dividends were substantially the same as before they received such dividends. They did not become creditors of the Corporation and their potential cash dividends from the Corporation were no greater than before, because, as Common stockholders, they had possessed complete control over the finances of the Corporation and could have caused dividends to be paid to themselves on their Common Stock in an amount equal to the dividends which would be paid on their

combined Common and Preferred Stocks after the Preferred Stock dividends had been declared.

The large earnings of the Corporation during its entire existence seemed to assure the ability of the Corporation to pay out of current earnings the comparatively small preferential dividends on its newly issued as well as on its already outstanding Preferred Stock. Its capital together with its large and constantly increasing surplus still further assured the ability of the Corporation to pay in full the preferential claims of all the Preferred stockholders in the remote contingency of liquidation. In the light of the foregoing conditions, the Common stockholders of the Warner Corporation received as a result of the Preferred Stock dividend nothing which added to the value of that which they already had; while, in the *Koshland* case, the Preferred stockholders received as a result of the Common Stock dividend something which added to that which they already had, their interest in the Corporation having been increased to the extent of the full value of the Common Shares which they received.

The preferences inherent in the Preferred Stock received as a dividend in the instant case would be of value *only* in case of great and unlikely decrease in corporate earnings and surplus. At the time of the distribution of the Preferred Stock dividend, the preferences involved were of no actual value because the Warner Corporation had a surplus amply sufficient to meet its dividend requirements. If the Warner Corporation had been liquidated immediately after the receipt of the Preferred Stock dividend, the stockholders who received such dividend would have participated to that extent in the assets of the Corporation as Preferred stockholders and consequently to an equivalently lesser extent as Common stockholders. The aggregate amount, therefore, which each stockholder would have received upon

liquidation, whether or not a Preferred Stock dividend had been declared, would have been precisely the same.

The foregoing illustrates the fundamental difficulty inherent in determining what stock dividends in the intermediate factual situations constitute Income. We have not only the question as to what degree of change in the proportionate interests of stockholders is necessary to meet the test that Income is realized, but the further question as to what is the measure of the Income when that which is received is taken from that which was had before.

In view of all the circumstances and facts present in the instant case, it is submitted that the distribution of the Preferred Stock dividend did not essentially change the Taxpayer's interest in the Warner Corporation. Any change which may have resulted certainly can not be measured by the full value of the Preferred Stock received.

## POINT III.

**The Circuit Court of Appeals correctly refused to consider (1) the contention of the Commissioner that the shares of Stock redeemed in 1931 had a zero basis, and (2) the alternative contention of the Commissioner that such Shares were Taxable as a Dividend under Section 115 (g) of the Revenue Act of 1928.**

1. In 1928 the Taxpayer received as a dividend upon her Common Stock of the Warner Corporation 12,582 shares of Preferred Stock of that Corporation. Subsequently, in 1931, the Corporation redeemed 2,000 of these shares, paying the Taxpayer therefor the sum of $200,000.

As provided in the Treasury Regulations then in effect requiring apportionment, the Taxpayer reported as capital gain in her Federal Income Tax Return for the year 1931 the sum of $180,100, approximately 90% of the $200,000 received from the redemption of her preferred stock, and paid

a capital gain tax of 12½% thereon. The Commissioner, in his Notice of Deficiency, eliminated the said sum of $180,100 from the gross and net Income of the Taxpayer and credited the Taxpayer with the 12½% tax so paid. The Commissioner, in his Notice of Deficiency, claimed that the amount of $200,000 received by the Taxpayer from the redemption of her preferred stock constituted a taxable dividend under the provisions of Section 115 (g) of the Revenue Act of 1928, and increased her gross and net Income by that amount. Clearly, therefore, the question of the taxability as capital gain of the $200,000, or any part thereof, was not an issue before the Board of Tax Appeals and was not, in fact, decided by the Board.

The Board held that the Taxpayer was not subject to taxation under the provisions of Section 115 (g) of the Revenue Act of 1928 upon the proceeds of the redemption of the 2,000 shares of Preferred Stock. The Board said:

> "The Commissioner held that the redemption of the 2,000 shares in 1931 was at such time and in such manner as to be substantially equivalent to a taxable dividend in 1931, within the meaning of section 115(g) of the Revenue Act of 1928. He erred in this since the dividend was subject to tax in 1928 (see cases above cited). Thereafter the shares had a basis for gain or loss to the petitioner of $100 each, and they were redeemed without gain or loss to the petitioner at $100 each in 1931." (R. 36).

In the brief which the Commissioner filed with the Circuit Court of Appeals, he contended *for the first time* that, if the dividend received by the Taxpayer in 1928 was *exempt from tax at the time of receipt,* under Section 115 (f), its basis to the Taxpayer was zero. The Circuit Court of Appeals refused to consider this point on the ground that:

> " • • • the issue was not raised before the Board nor decided by it nor assigned as error in the peti-

tion to this court for a review of the Board's decision * * *."

2. As an alternative contention, the Commissioner urged in his brief in the Circuit Court of Appeals that, if the 2,000 shares of stock redeemed in 1931 did not have a zero basis, such shares were taxable as a dividend under Section 115 (g) of the Revenue Act of 1928. The Circuit Court of Appeals also refused to consider this point upon the ground that "the Commissioner did not file a cross appeal". In addition the Court stated:

> "By the provisions of section 115 (g) the proceeds of the redemption of the stock can be taxed only if it occurs at such time and in such manner as to make the redemption essentially equivalent to the distribution of a taxable dividend. Since the Board did not so find, we cannot support this contention. (Helvering v. Rankin, 295 U. S. 123)."

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It should be borne in mind that in the Deficiency Notice herein the Commissioner determined a deficiency of $125,660.67, by reason of adding to the Taxpayer's net income:

(1) $629,125.00, representing the value of the 1931 stock dividend, upon the stated ground that such dividend was taxable under Section 115 (f).

(2) $200,000.00, representing the proceeds of redemption of 2,000 shares, upon the stated ground that such redemption was taxable under Section 115 (g).

The Taxpayer thereupon appealed to the Board of Tax Appeals for a redetermination of the two foregoing issues. The Board sustained the Commissioner as to the issue concerning the item of $629,125.00, but overruled the Commissioner as to the issue concerning the item of $200,000.00,

and the result thereof was a determination of a deficiency against the Taxpayer in the sum of $89,841.75.

Thereafter the Taxpayer filed a petition with the Circuit Court to review the adverse determination of the first issue. The Commissioner filed no cross-appeal to the Circuit Court as to the second issue which had been determined by the Board adversely to him.

The Commissioner now contends that the Circuit Court of Appeals erred in refusing to pass upon these two alternative points.

That the Circuit Court of Appeals was correct in refusing to consider either of these points is well settled. A Respondent who does not take a cross-appeal nor assign errors cannot raise alleged errors in the Circuit Court of Appeals.

As stated by the Circuit Court of Appeals for the First Circuit in *Swig* v. *Tremont Trust Co.*, 8 Fed. (2d) 943, 945:

> "But the trust company did not except to this ruling, so far as the record shows, and has filed no cross-appeal and assignment of errors complaining of it. We are therefore of the opinion that this question is not before us."

Consequently, the Court below properly refused to consider the applicability of Section 115 (g) of the Revenue Act of 1928.

In any event, there are no facts before this Court upon which to base a judgment on the question involved and, as the application of Section 115 (g) is solely a factual question, we will not discuss it further in this brief.

Even more clearly, the contention that the basis of the shares received by the Taxpayer in 1928 was zero was not before the Circuit Court for consideration, since not only was this contention not properly presented to the Circuit Court, but it was not even suggested to the Board.

The Commissioner, in support of his contention that the question of the basis was at issue before the Board, quotes a portion of the opinion of the Board in which the Board said that "the shares had a basis for gain or loss to the petitioner of $100". This statement of the Board, however, was not made in discussing or deciding the issue of the zero basis. This statement was made to fortify the conclusion that the sum of $200,000 was not subject to taxation as a dividend under Section 115 (g). The Board did not undertake to decide whether or not the Taxpayer derived a capital gain from the redemption of the 2,000 shares and did not, in its opinion, imply that this issue was before it for review.

In *General Utilities & Operating Company* v. *Helvering*, 296 U. S. 200, 206, the Court ruled in an identical situation:

> "The second ground of objection, although sustained by the court, was not presented to or ruled upon by the Board. The petition for review relied wholly upon the first point; and, in the circumstances, we think the court should have considered no other. Always a taxpayer is entitled to know with fair certainty the basis of the claim against him."

*Helvering* v. *Salvage*, 297 U. S. 106, 109, is to the same effect.

The cases cited by the Government on the proposition that any argument may be offered in support of the judgment below have no application. The Government is seeking here, not to support the judgment of the Board, but to have this Court reverse the determination of the Board in respect of an issue (Section 115 (g)) that was decided adversely to the Government and further, to have this Court consider and decide the question of the cost basis of shares of stock—an issue not presented to the Board.

Since neither the point that the redemption of Taxpayer's shares in 1931 was taxable as a dividend under

Section 115 (g) of the Revenue Act of 1928, nor the point that such shares had a zero basis was properly before the Circuit Court of Appeals, neither point can be urged by the Commissioner in this Court as a ground for reversal.

## POINT IV.

**The Basis to the Taxpayer of the Preferred Stock, received by her as a dividend in 1928, is the Fair Market Value of such stock at date of receipt.**

Assuming that the issue as to the basis of the preferred stock was properly raised in the Board of Tax Appeals and in the Circuit Court of Appeals, and assuming further that the stock dividend constituted Income, it is submitted that, on the merits of the question, the basis of these shares is their fair market value at the time of receipt by the Taxpayer.

The Government will concede, we assume, that, if Section 115 (f) did not exempt from taxation the stock dividend received by the Taxpayer in 1928, the basis of the dividend shares was their fair market value. The contention of the Government that the basis of the dividend shares is zero is predicated entirely upon the proposition that, if these shares were exempt from tax when received, the full amount realized by the Taxpayer upon their disposition should be subjected to tax. But as pointed out by this Court in the *Koshland* case:

> "Whether Congress has taxed 'the dividend' as of the time of its receipt, is immaterial."

That this is so is clear from the fact that the argument offered by the Government in support of the contention that the basis of the shares in question was zero is grounded upon the principle that the Taxpayer acquired these shares "without any new investment". But no "new investment"

is made by the recipient of a *taxable property dividend.* If, therefore, the zero basis theory depends upon the no "new investment" principle, the recipient of a taxable property dividend would be subject to taxation upon the full value thereof at the time of its receipt and again at the time of the sale or disposition of the property so received. The utter fallacy of the Government's argument is thus exposed.

Section 113 of the Revenue Act of 1928 expressly declares that the statutory basis for determining gain or loss from the sale or other disposition of property is its "cost" (*Koshland* v. *Helvering, supra*). Where property is acquired by purchase the term "cost" is synonymous with the term "purchase price", but this Court has expressly held that where property does not have a "cost" in the conventional sense and the applicable Revenue Act does not prescribe otherwise, the basis of the property is the fair market value thereof at the time of acquisition by the taxpayer. In *Hartley* v. *Commissioner,* 295 U. S. 216 (1935), the Court said:

> "The Court of Claims held that the time of acquisition, indicated by Sec. 202 (a) of the 1921 Act and Sec. 204 (a) of the 1924 and 1926 Acts as the controlling date for calculating gain or loss to the estate in the course of administration, must be taken to be the date of acquisition by the decedent rather than the time of acquisition by the executor or administrator on the decedent's death. This conclusion, it was thought, was compelled by the statutory command that the basis of computation shall be 'cost', which could have no application to the acquisition by the executor or administrator, who is not a purchaser of the estate which he administers. McKinney v. United States, supra (62 Ct. Cl. 188). But this specification is not enough to restrict the effect of the general provisions of these revenue acts which impose a tax on the income, including capital gains, of taxpayers. *The*

*use of the word cost does not preclude the computation and assessment of the taxable gains on the basis of the value of property, rather than its cost, where there is no purchase by the taxpayer, and thus no cost at the controlling date.* See Heiner v. Tindle, 276 U. S. 582, 585, 586, 72 L. ed. 714, 716, 717, 48 S. Ct. 326; Lucas v. Alexander, 279 U. S. 573, 578, 579, 73 L. Ed. 851, 854, 855, 49 S. Ct. 426, 61 A. L. R. 906." (Emphasis supplied.)

The case of *Heiner* v. *Tindle*, 276 U. S. 582, which arose under the Revenue Act of 1918, involved the sale of a dwelling house originally acquired and used by the taxpayer as his residence, but which had subsequently been leased by him. The sale of the property resulted in a loss. The property had been leased prior to March 1, 1913, and the question considered by this Court was whether the basis for determining the taxpayer's loss should be the fair market value of the property as of March 1, 1913, or the fair market value in 1901 when the property was first leased. This Court decided that if the 1901 value was less than the value of the property in 1913, the value at the earliest date represented the basis for determining the loss. In the course of its opinion, this Court said:

> "But it is pointed out that sec. 202 of the Revenue Act of 1918, prescribing the method of computing gain or loss upon the sale of property, makes value as of March 1, 1913, or cost if acquired later, the basis of the computation. * * *
>
> "But it is obvious that sec. 202 is not all inclusive. The same and no greater inconsistency and difficulty arise in the case of property acquired by gift, bequest or devise, when market value at the time of acquisition by the donee and not cost is necessarily the basis of computing the tax. That in such cases the difference between the sale price and market value at the date of acquisition, if after March 1, 1913, is deductible under subsection (a) 5, is not questioned."

This rule that the basis of property acquired otherwise than by purchase—in the absence of an express statutory provision prescribing some basis other than "cost"—is the fair market value of such property when acquired, is so well established as to be virtually axiomatic. The principle has been consistently recognized by the Board of Tax Appeals and the Courts, and has been applied to a variety of situations, irrespective of whether the acquisition of the property resulted in taxable income. *Francis* v. *Commissioner*, 15 B. T. A. 1332; *Bankers Trust Company* v. *Commissioner*, 24 B. T. A. 10; *Lucas* v. *Daniel*, 45 Fed. (2d) 58 (C. C. A. 5); *Gowran* v. *Commissioner, supra*, now pending before this Court on Writ of Certiorari.

The Government applied this same principle in Regulations 45, Article 1562 (relating to the Revenue Act of 1918) to property acquired by gift, bequest, devise or descent—the Revenue Act of 1918 prescribing no exception to the general rule that the basis of property so acquired after February 28, 1913, is its "cost". The Article just referred to reads as follows:

> "In the case of property acquired by gift, bequest, devise or descent, the basis for computing gain or loss on a sale is the fair market price or value of the property at the date of acquisition. * * *"

To the same effect is G. C. M., 2861, C. B. VII-1, 255.

***The Koshland Case.***

The Commissioner contends that the conclusion that the basis of the preferred shares is zero seems to follow from the decision of this Court in the *Koshland* case. Just how the decision in the *Koshland* case can be regarded as authority for the Commissioner's present contention is not clear. In the *Koshland* case the taxpayer acquired certain shares of preferred stock by *purchase*. Subsequently, the tax-

payer received a dividend upon these shares in the form of common stock in the same corporation. The original (preferred) shares were later sold. *This* Court held that the basis of such shares could not be reduced by allocating a portion of their cost to the common shares received as a dividend. It was consequently held that the "cost" of the original preferred shares—the amount paid therefor by the taxpayer—represented the proper basis of such shares to the taxpayer as prescribed by the Statute (Section 113, Revenue Act of 1928). The only question presented to this Court in the *Koshland* case was the correct basis of the *original shares;* the question as to the basis of the *dividend shares* was not even inferentially considered by this Court in that case.

Clearly, therefore, the *Koshland* decision lends no support to the contention that the Taxpayer has a zero basis for the Preferred shares received by her as a dividend upon her Common stock in William R. Warner Corporation. Indeed, the principle of the decision in the *Koshland* case compels a contrary conclusion.

The rule that, where property is acquired otherwise than by purchase, the "cost" of such property is its value when acquired has thus become definitely established. Regardless of how property is acquired, whether by purchase, gift, descent or corporate distribution, it becomes new capital in the hands of the recipient. Only the gain subsequently derived from such capital, including the profit realized from a sale of the capital asset, is income and taxable as such.

The shares of preferred stock received by the Taxpayer as a dividend in 1928 had a value of $100 per share (R. 16). Since the price at which these shares were redeemed was the same as the value thereof when acquired by the Taxpayer, it follows that no gain or loss resulted to the Taxpayer upon the redemption of her preferred shares.

## *Conclusion.*

***The decision of the Circuit Court of Appeals should be affirmed.***

Respectfully submitted,

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October 15, 1937.

## APPENDIX.

REVENUE ACT OF 1921:

Section 201. • • •

"(d) A stock dividend shall not be subject to tax but if after the distribution of any such dividend the corporation proceeds to cancel or redeem its stock at such time and in such manner as to make the distribution and cancellation or redemption essentially equivalent to the distribution of a taxable dividend, the amount received in redemption or cancellation of the stock shall be treated as a taxable dividend to the extent of the earnings or profits accumulated by such corporation after February 28, 1913."

REVENUE ACT OF 1928:

*Section 115. Distributions by Corporations.*

"(a) Definition of dividend.—The term 'dividend' when used in this title (except in Section 203 (a) (4) and Section 208 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.

• • • • • • • • •

(f) *Stock dividends*—A stock dividend shall not be subject to tax.

• • • • • • • • •

Section 201 (a) of the Revenue Acts of 1924 and 1926 and Sections 115 (a) of the Revenue Acts of 1928, 1932 and 1934 are substantially identical with subdivision (a) of Section 115 of the Revenue Act of 1928.

• • • • • • • • •

Sections 201 (f) of the Revenue Acts of 1924 and 1926 and Sections 115 (f) of the Revenue Acts of 1928, 1932 and 1934 are identical with Section 115 (f) of the Revenue Act of 1928.